
Gas Procurement Incentive OIR

R.08-06-025

Re-integration and Management of Hedging within the Utilities' Procurement Incentive Mechanisms

November 5, 2008

Underlying Commission Objectives in the OIR

- **Achieve low cost & mitigate volatility**
- **Align the interests of ratepayers & shareholders**
- **Introduce accountability & consequences for utility procurement activities**
- **Provide objective measures of performance**
- **Reduce Commission resources dedicated to oversight**

Achieve the Commission's Supply Portfolio Goals

- In the OIR, the Commission identified two supply portfolio goals:
 - q Low Cost
 - q Price Volatility Mitigation
- Low cost procurement is achieved by comparing utility gas purchase costs to benchmark prices that reflect market prices
- Volatility mitigation can be achieved by comparing utility supply portfolio price volatility to benchmark price volatility
- The benchmark prices from the incentive mechanisms can be used:
 - q As objective measures of “market” price volatility
 - q To assess utility supply portfolio volatility
 - q As a basis against which the Commission can establish price volatility reduction targets

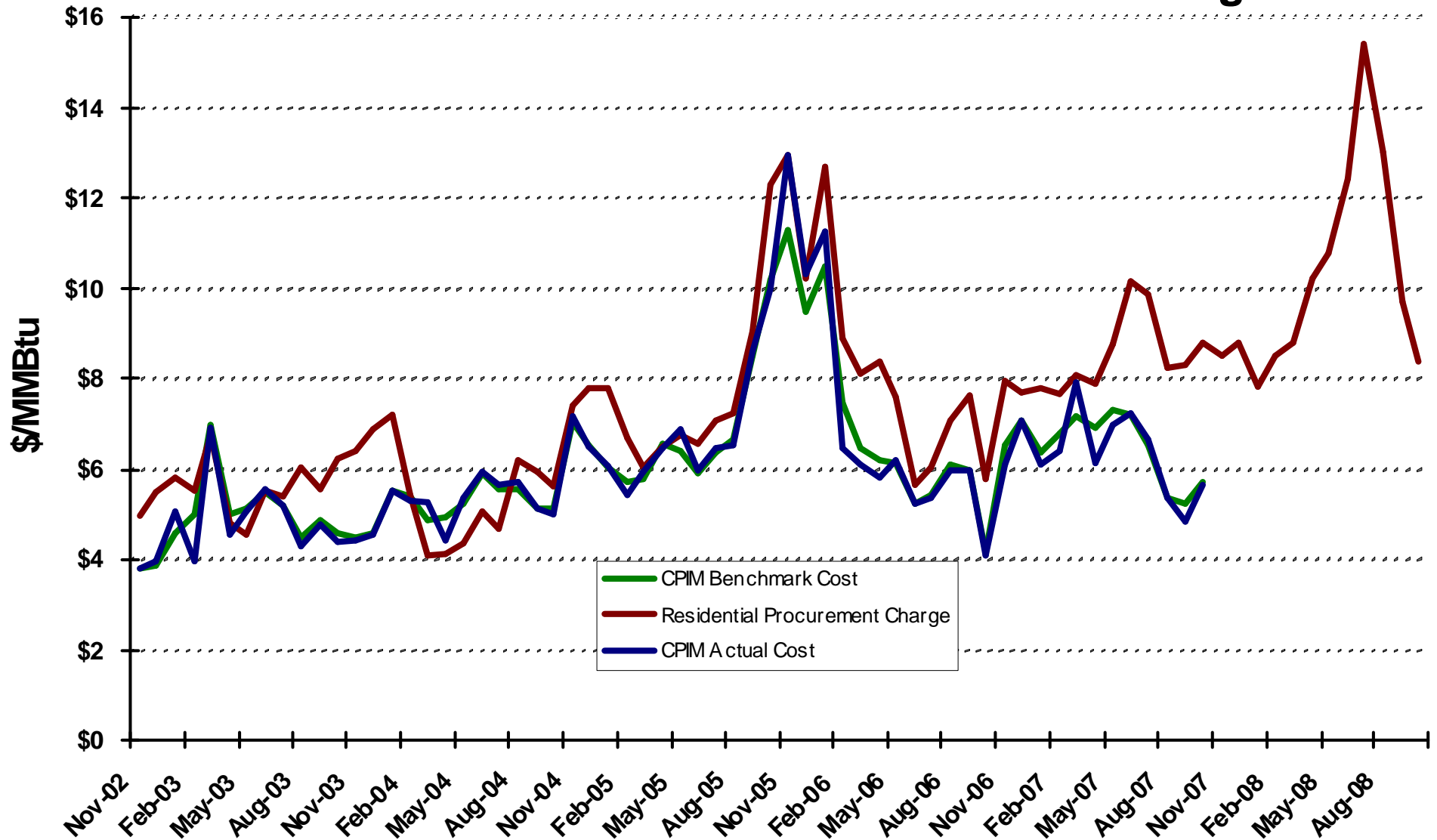
What is Price Volatility?

- Price volatility is:
 - q the variation in price from the average price over a period of time
 - q the annualized standard deviation of monthly price changes
- For example, SoCalGas' Dec '07 to Nov '08 procurement charge averaged \$8.37 per MMBtu with an annualized monthly volatility of 66.5%
- Therefore, over the next year, SoCalGas' procurement charge is expected to range between \$2.80 and \$13.93 per MMBtu with a 68.3% probability (1 standard deviation)

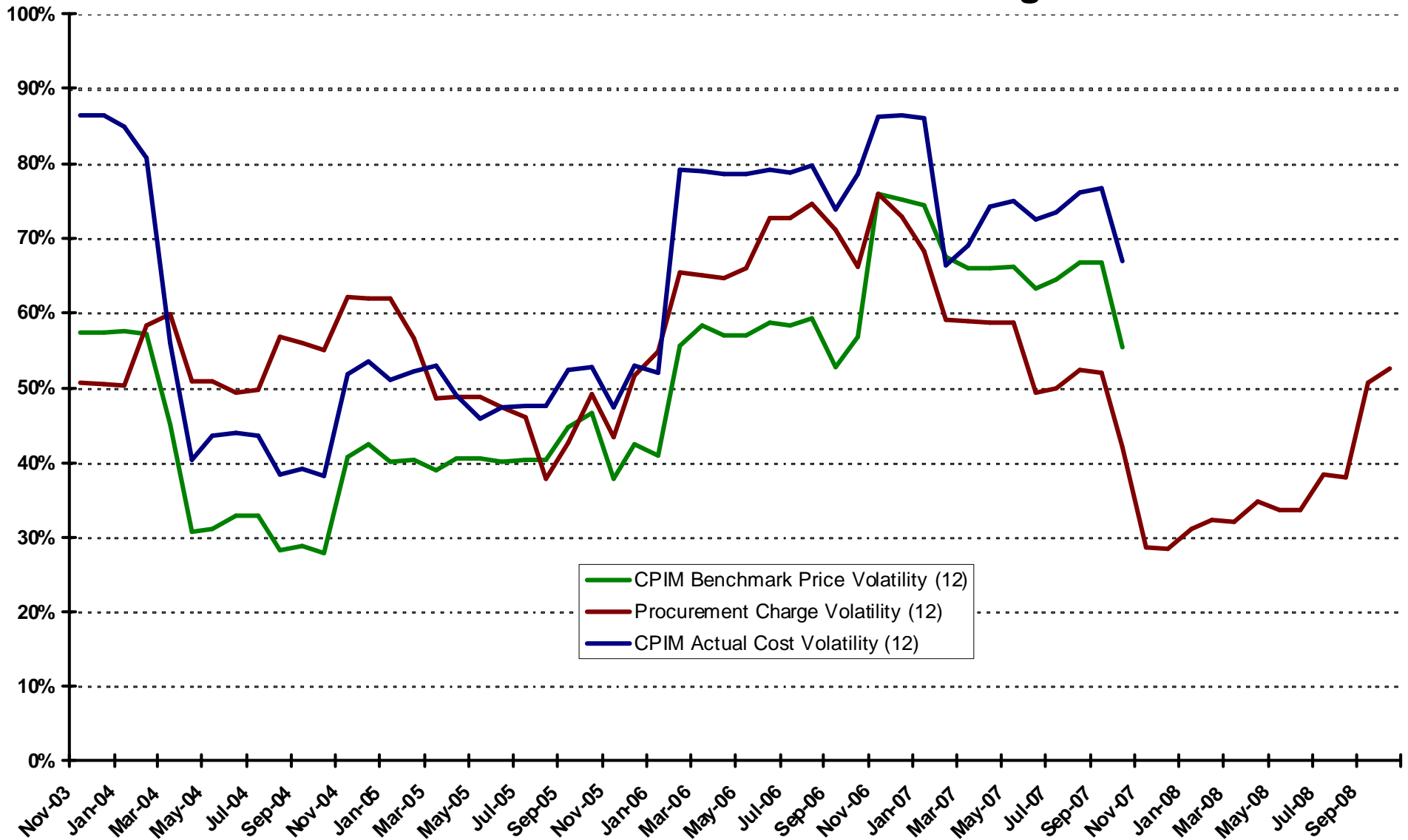
Price Volatility within PG&E and SoCalGas' Portfolios

- PG&E and SoCalGas' existing core portfolios mirror and pass through market prices and market price volatility to core procurement customers
- There is no volatility mitigation resulting from the utilities' winter hedging programs
- Volatility in the market (and within the utilities' portfolios) is high not only during winter months, but all year round

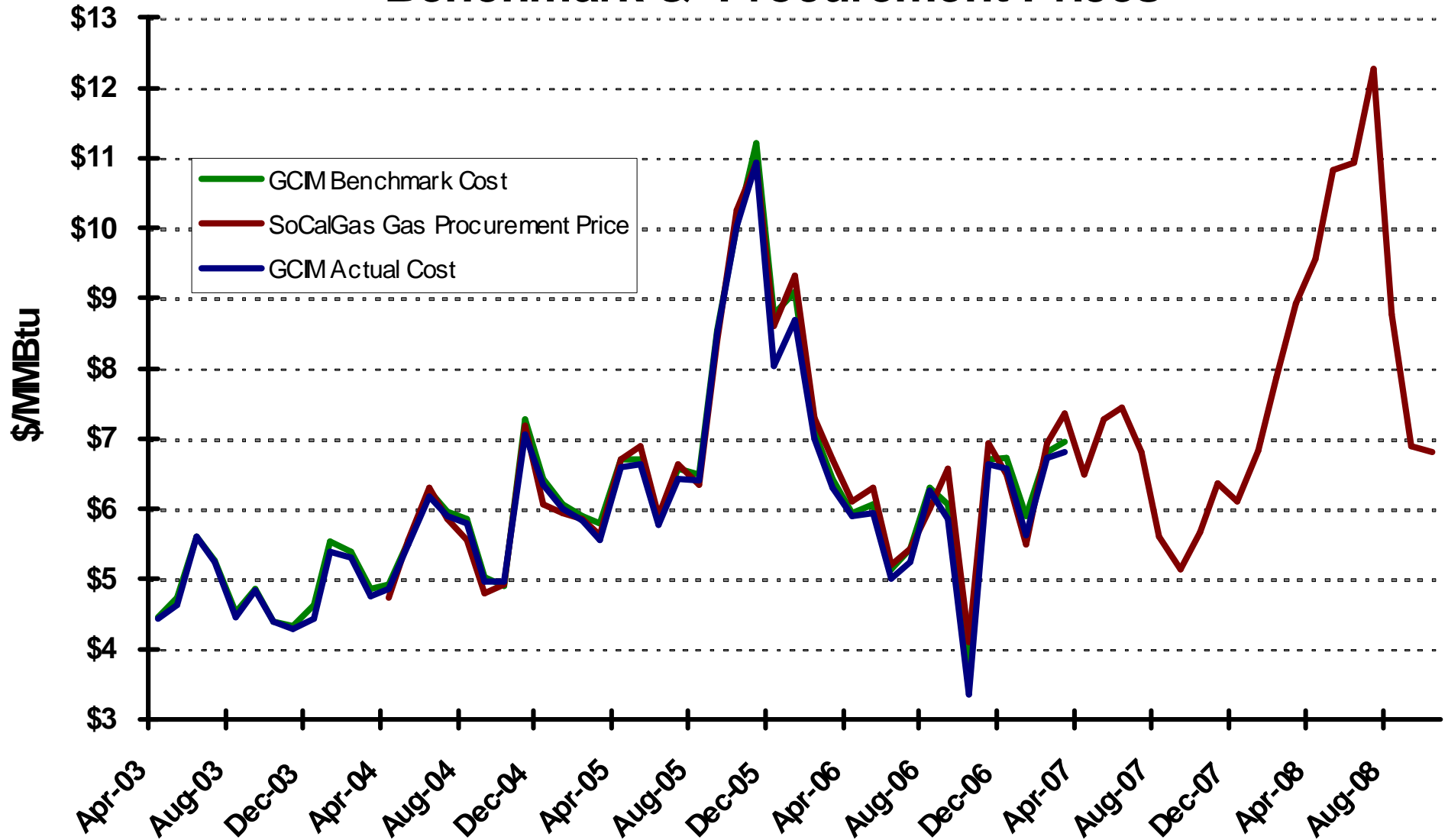
PG&E Price Summary: CPIM Actual, CPIM Benchmark & Residential Procurement Charge



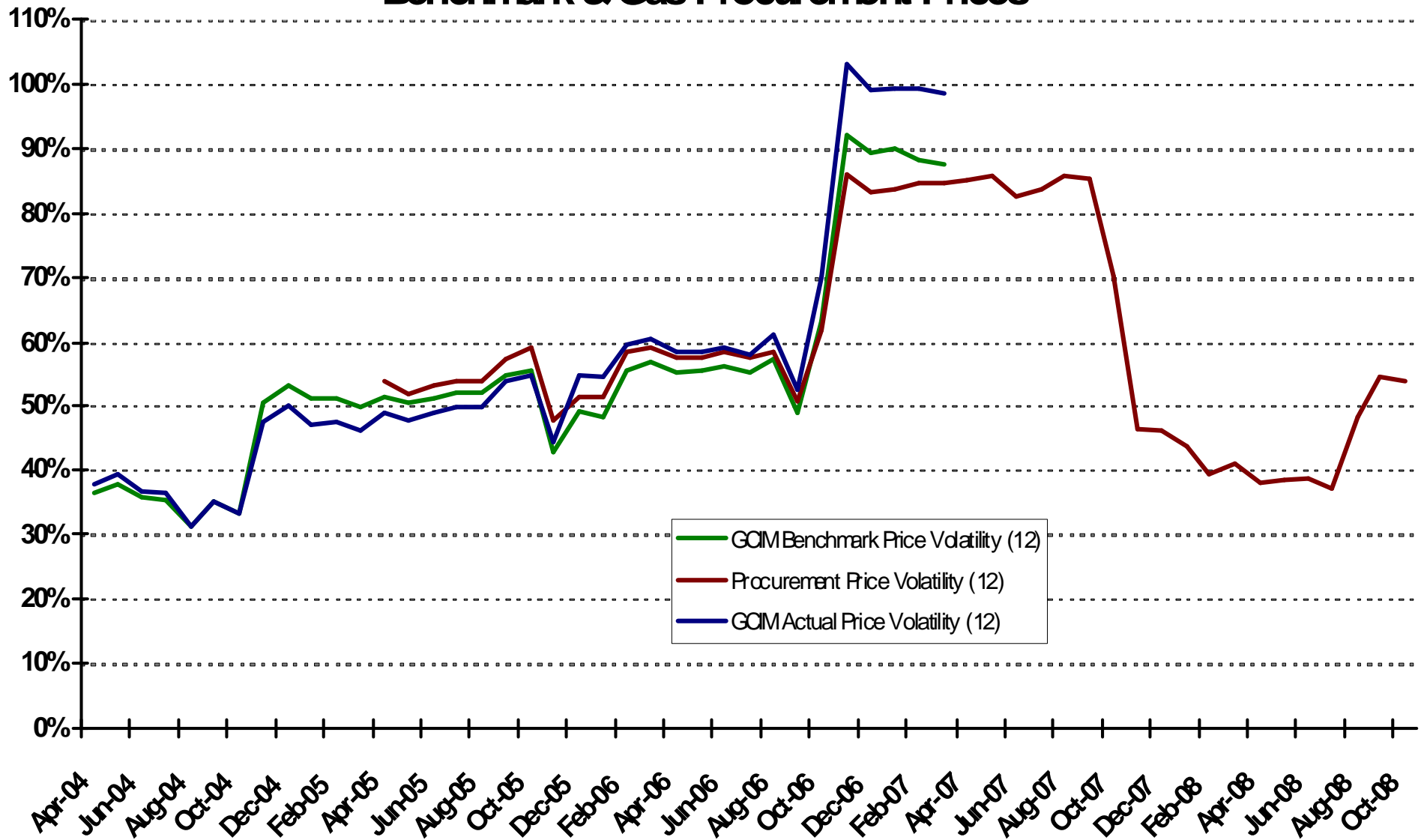
Volatility of PG&E's CPIM Actual, CPIM Benchmark & Residential Procurement Charges



SoCalGas Price Summary: GCIM Actual, GCIM Benchmark & Procurement Prices



Volatility of SoCalGas' GCIM Actual, GCIM Benchmark & Gas Procurement Prices



Supply Portfolio Price Volatility Mitigation

- Using benchmark price volatility as an objective standard, the Commission can target reductions in utility supply portfolio price volatility
- The Commission should establish a target based on ratepayers' tolerance for risk. For example:
 - q Portfolio price volatility = 70% of benchmark price volatility
 - q This target would require the utilities to hedge between 25% and 50% of core portfolio demand
- A portfolio price volatility target can be readily incorporated within the existing incentive mechanisms

Align the Interests of Ratepayers and Shareholders

- The current incentive structure discourages the utilities from hedging due to potential shareholder risk exposure
- The current winter hedging structures have no risk / reward component and impose no accountability and consequences on the utilities
- The Commission should incorporate risk / reward structures in the incentive mechanisms that:
 - q Encourage low cost procurement strategies
 - q Promote mitigation of price volatility
 - q Impose accountability on the utilities for all of their procurement related activities
 - q Address shareholder risk exposures

Align the Interests of Ratepayers and Shareholders

- The risk / reward structure should provide an incentive for the utilities to hedge:
 - q 85% / 15% sharing when procurement costs are below the benchmark, subject to a \$30 MM annual shareholder reward cap
 - q 98% / 2% sharing when procurement costs are above the benchmark, subject to a \$6 MM shareholder penalty cap
 - q A bonus payment (or penalty) of \$4 MM or \$8 MM (utility specific) if the Commission's volatility reduction target IS (or IS NOT) met

Align the Interests of Ratepayers and Shareholders

- Under this incentive structure, the Commission would:
 - q Motivate the utilities to achieve low costs
 - q Motivate the utilities to mitigate volatility
 - q Align the interests of ratepayers and shareholders
 - q Introduce accountability and consequences
 - q Provide objective measures of performance

Impact of Adopting the Proposed Structure

- All utility commodity procurement activities will be managed within the incentive mechanisms
- A single incentive structure for all core procurement activities will:
 - q Reduce the Commission's resources dedicated to oversight
 - q Simplify the review process
 - q Impose accountability and consequences on the utilities

Impact of Adopting the Proposed Structure

- The Utilities will be motivated to:
 - q Achieve the Commission's procurement objectives throughout the year
 - q Focus on procurement over multi-year terms; beyond the current month-to-month (or winter-only) timeframe
 - q Leverage their fundamental, technical and risk management skills
 - q Develop risk management strategies tailored to their specific needs

Summary of the Proposed Modifications to the Incentive Mechanisms

- Monthly benchmark prices remain the standard against which utility procurement is measured
- Benchmark price volatility is determined from benchmark prices
- The utilities' actual monthly procurement costs, including the cost of all hedged products, are compared to the monthly benchmark price
- Tolerance bands are eliminated given the proposed risk/reward structure
- Sharing percentages are simplified:
 - q 85 / 15 (when costs are below the benchmark)
 - q 98 / 2 (when costs exceed the benchmark)

Summary of the Proposed Modifications to the Incentive Mechanisms

- Annual rewards and penalties associated with commodity procurement are capped at \$30 MM and \$6 MM, respectively
- Each year, the price volatility of the utilities' core supply portfolio is compared to the benchmark price volatility
- If the utility's portfolio volatility is $< 70\%$ of the benchmark volatility, a reward of \$4 MM or \$8 MM (utility specific) is applied
- If the utility's portfolio volatility is $> 70\%$ of the benchmark volatility, a penalty of \$4 MM or \$8 MM (utility specific) is applied
- If a utility fails to achieve the Commission's volatility reduction target over consecutive years, the penalty doubles each year (\$4 MM, \$8 MM, \$16 MM... or \$8 MM, \$16 MM, \$32 MM...)

Procurement Protocols

- The utilities claim they require confidentiality regarding their hedging activities to protect ratepayers
- The utilities' concern is that disclosure of their hedging activities would allow market participants to take positions for themselves first, driving up the price of hedge products before the utilities transact
- Notwithstanding, the utilities disclose their hedging activities to a select group of very sophisticated trading counterparties (who can take positions in advance of the utility)
- As such, confidentiality does nothing to address the utilities' stated concern

Procurement Protocols

- The utilities' winter hedging is expensive and fails to provide ratepayer benefits
- The benefits of informed scrutiny and assessment would more than offset the claimed downside of transparency
- SCE conducts very public and very large solicitations through which they procure long-dated products
- Likewise, California's gas utilities can solicit products from a large group of creditworthy counterparties to meet their procurement needs



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